DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0308
Indiana Corporate Income Tax
For 1998 and 1999

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Applicability of the Throw-Back Rule – Adjusted Gross Income Tax.

Authority: 15 U.S.C.S. § 381; 15 U.S.C.S. § 381(a), (c); 15 U.S.C.S. § 381(a)(1); 15 U.S.C.S. § 381(c); 15 U.S.C.S. §§ 381 to 384; Public Law 86-272; IC 6-3-1-25; IC 6-3-2-2; IC 6-3-2-2(e); IC 6-3-2-2(n); IC 6-3-2-2(n)(1); IC 6-3-2-2(n)(2); Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447 (1992); First Chicago NBD Corp. v. Dept. of State Revenue, 708 N.E.2d 631 (Ind. Tax Ct. 1999); Kennametal, Inc. v. Commissioner of Revenue, 686 N.E.2d 436 (Mass. 1997); 45 IAC 3.1-1-53(5); 45 IAC 3.1-1-64; Jerome R. Hellerstein and Walter Hellerstein, State and Local Taxation: Cases and Materials (7th ed. 2001); Personal Income Tax – Nexus Standards (Ohio Dept. of Taxation, Sept. 2001).

Taxpayer argues that the Department of Revenue (Department) erred when it determined that money earned from sales of its truck parts to out-of-state customers was subject to Indiana's adjusted gross income tax.

II. Abatement of the Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer maintains that it is entitled to an abatement of the ten-percent negligence penalty. Taxpayer concludes that the assessments of additional tax, upon which the penalty is based, were the results of the Department's own incorrect application of the throw-back rule.

STATEMENT OF FACTS

Taxpayer is an Indiana business which sells truck parts. Taxpayer sells truck parts to Indiana customers, to out-of-state customers, and to customers outside the United States. The Department conducted a review of taxpayer's business records and tax returns determining that the receipts obtained from sales to out-of-state customers should be "thrown back" to Indiana. This decision resulted in the assessment of additional corporate income tax. Taxpayer disagreed with the audit's decision regarding the throw-back sales along with the consequent assessment of additional corporate income tax; taxpayer submitted a protest to that effect. Two administrative

hearings were conducted during which taxpayer explained the basis for its protest. This Letter of Findings results.

DISCUSSION

I. Applicability of the Throw-Back Rule – Adjusted Gross Income Tax.

The audit concluded that the receipts taxpayer obtained from sales to its out-of-state and foreign customers should be included in the numerator of the sales factor. The audit made this decision because it found that all of taxpayer's property, inventory, and payroll were located in Indiana and because taxpayer "do[es] not file tax returns in any other state." Taxpayer disagrees maintaining that the receipts earned from the out-of-state and foreign customers should not have been thrown-back to Indiana.

The audit determined that, for purposes of calculating taxpayer's Indiana tax liability, the receipts from sales to out-of-state customers and foreign customers should be thrown back to Indiana because the sales were made within jurisdictions where the taxpayer was not subject to another jurisdiction's income tax. The audit based its decision on 45 IAC 3.1-1-53(5) which states that "[i]f the taxpayer is not taxable in the state of the purchaser, the sale is attributed to [Indiana] if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state." Such sales are designated as "throw-back" sales. Id.

The basic rule is found at IC 6-3-2-2. IC 6-3-2-2(e) provides that "[s]ales of tangible personal property are in this state if . . . (2) the property is shipped from an office, a store, a warehouse, a factory, or other place of storage in this state and . . . (B) the taxpayer is not taxable in the state of the purchaser." IC 6-3-2-2(n) provides that "[f]or purposes of allocation and apportionment of income . . . a taxpayer is taxable in another state if: (1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business or a corporate stock tax; or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not." Therefore, in order to properly attribute income to a foreign state, taxpayer must show that one of the taxes listed in IC 6-3-2-2(n)(1) has been levied against him or that the state has the jurisdiction to impose a net income tax regardless of "whether, in fact, the state does or does not." Id.

Therefore, whether or not Indiana can tax receipts an Indiana resident has received from non-Indiana customers depends on whether another jurisdiction subjects that same taxpayer to that foreign jurisdiction's own income tax. However, Congress passed a law which restricts the states' authority to tax income received from interstate business activities. The law is codified at 15 U.S.C.S. §§ 381 to 384 but is generally referred to as Public Law 86-272. Public Law 86-272 prohibits states from imposing a net income tax on an out-of-state taxpayer if that foreign taxpayer's only business activity within the state is the solicitation of sales. A state may not impose an income tax on income derived from business activities within that state unless those in-state activities exceed the "mere solicitation" of sales. 15 U.S.C.S. § 381(a), (c). The effect of the throw-back rule is to revert sales receipts back to the state from where the goods were shipped in those instances where 15 U.S.C.S. § 381 deprives the purchaser's own home state of the power to impose a net income tax. 45 IAC 3.1-1-64. In effect, 15 U.S.C.S. § 381 permits

Indiana to tax out-of-state business, without violating the Commerce Clause and without the possibility of subjecting taxpayer to double taxation, because Indiana's right to tax those out-of-state activities is derivative of the foreign state's own taxing authority. In every sales transaction, at least one state has the authority to tax the receipts obtained from the sale of the tangible personal property; if the state wherein the sale occurred is forbidden to do so by 15 U.S.C.S. § 381, then the income is "thrown-back" to the originating state.

Taxpayer's argument is based on the premise that its activities outside Indiana exceed the solicitation activities described in 15 U.S.C.S. § 381(a). 15 U.S.C.S. § 381(a)(1) confers immunity from state income taxes on any taxpayer whose "only business activities" in that state consists of "solicitation of orders" for interstate sales. Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447, 2453 (1992). If taxpayer's activity in a particular state consists of more than the "solicitation of sales," then Indiana may not tax the income received from customers located within that particular foreign state.

Taxpayer does business by means of independent agents in numerous foreign states. According to taxpayer, its agents conduct the following activities:

> The independent agents, solicit, secure, and accept orders for truck parts. According to taxpayer, the agent has the final authority to "accept" the orders; taxpayer's Indiana office will only intervene in an order acceptance if there has been a previous "problem with receivables."
>
> The independent agents handle customer complaints.
>
> The independent agents "get involved with collection issues if a customer is delinquent in paying its invoices."
>
> The independent agents are involved with issues stemming from defective merchandise. The independent agents are authorized see that the defective item is repaired or returned. In addition, the independent agents become involved if a customer credit needs to be issued to the complaining customer.

In addition, taxpayer has provided correspondence from a number of its out-of-state independent sales agents to bolster its argument that the activities of those agents exceed the bounds of "mere solicitation." The correspondence describes how the agents deal with certain credit issues, provide customers with sales literature, become involved with delinquent customers, answer customer complaints, and act as taxpayer's "eyes, ears, and arms in [the salesperson's] defined territory." As one of the sales agents puts it, "We contact customers to sell [taxpayer's] products and perform all detail tasks necessary to complete the sale and continue the relationship successfully."

Public Law 86-272 does not define what constitutes "solicitation of orders." The Supreme Court concluded that the solicitation of orders "covers more than what is strictly essential to making request for purchases." Wrigley 112 S.Ct. at 2456. As such, some activities within the state may involve more than a direct request for the purchase of goods but, nonetheless, are still protected

from state tax under Public Law 86-272. However, the Court in Wrigley drew a "clear line . . . between those activities that are entirely ancillary to requests for purchase--those that serve no independent business function apart from their connection to the soliciting of orders--and those activities that the company would have reason to engage in anyway but chooses to allocate to its in-state sales force." Id. Nevertheless, the Court also stated that "employing salesmen to repair or service the company's products is not part of the 'solicitation of orders,' since there is good reason to get that done whether or the not the company has a sales force. Repair and servicing may help to increase purchases; but it is not ancillary to requesting purchases, and cannot be converted into 'solicitation' by merely being assigned to salesmen." Id.

In addition, the Wrigley Court also held that Public Law 86-272 could protect any activity from state taxation if the activity qualified under a de minimis exception. Id. at 2457-58. To qualify for this de minimis exception, the court must consider the activities of the taxpayer within the state as a whole. Id. Specifically, "[W]hether in-state activity other than 'solicitation of orders' is sufficiently de minimis to avoid loss of the tax immunity conferred by [Public Law 86-272] depends on whether that activity constitutes a nontrivial additional connection with the taxing State." Id. at 2458.

There is no bright-line test to determine whether taxpayer's activities within the foreign state are entirely ancillary to the solicitation of orders from those activities that serve an independent business function. Id. at 2456-57. There is no bright-line test to determine whether taxpayer's activities – other than the solicitation of sales – come within the definition of "de minimis." Id. at 2458. The activities of its independent agents – handling complaints, dealing with credit problems, resolving problems stemming from defective merchandise – occur along a continuum between those activities which are plainly related to the solicitation of orders and those activities which are clearly ancillary to solicitation. "In the end, business activities conducted with a State must be considered on an individual basis." Kennametal, Inc. v. Commissioner of Revenue, 686 N.E.2d 436, 441 (Mass. 1997).

Taxpayer has provided information which demonstrates that its independent agents perform activities which are outside the textbook definition of "solicitation." However, the Department is unable to conclude that these activities – when considered as a whole – are such that these activities would constitute a waiver of Public Law 86-272 immunity and subject taxpayer to another state's taxing authority. Some of the activities noted by taxpayer – providing literature and acting as the taxpayer's "eyes and ears" – are activities closely related to the solicitation of customer sales. Other activities such as resolving problems related to defective merchandise or billing and shipping problems are either closely related to the solicitation of the original sale or are sufficiently de minimis that taxpayer could reasonably argue that it is not subject to that state's income tax.

In addition, although it is not dispositive on the question, it should be noted that there is no indication that taxpayer has been subjected to any other state's net income tax. The Indiana law states that Indiana may tax receipts from out-of-state sales if the foreign "state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not." IC 6-3-2-2(n)(2). However, in determining whether Indiana may or may not throw back these sales receipts, it is noteworthy that no other state has determined that taxpayer's activities

with that foreign state abrogate taxpayer's Public Law 86-272 immunity. It may reasonably assumed that a foreign state – having presumably superior knowledge of taxpayer's activity within that particular state – is in a better position to judge whether taxpayer is subject to that state's own net income tax.

The audit was correct in concluding that the receipts from these sales should be thrown back to Indiana.

A. Ohio Sales Income.

Taxpayer maintains that there is "further support for nexus with Ohio." Taxpayer argues that its independent representative's activities inside Ohio bring taxpayer within the orbit of Ohio's income tax scheme. To that end, taxpayer recites from Ohio's "Information Release" stating that an entity – such as taxpayer – "does not have protection from [Public Law] 86-272 if the following activities are conducted in Ohio: having a sales representative or independent contractor conducting activities to establish or maintain the market for the entity; making repairs to the items sold; resolving customer complaints; accepting orders; handling collections; and issuing credits."

The Department defers to Ohio's interpretation of its own income tax laws. However, as the Ohio's Information Release states, "The limitations and extent of [Ohio's] jurisdiction to impose tax is an evolving area and this information release is not intended to be an all encompassing or all inclusive description of this subject." Personal Income Tax – Nexus Standards (Ohio Dept. of Taxation, Sept. 2001).

The Department agrees that taxpayer – by virtue of its independent agents – may bring itself within Ohio's taxing authority. However, a determination of whether taxpayer is or is not subject to that state's net income tax does not hinge on whether taxpayer's independent agents sell its truck parts to Ohio customers. "The immunity statute [Public Law 86-272] extends to the use of sales representatives, that is persons who are not employees but are independent contractors soliciting orders or making sales of tangible property for the out-of-state vendor." Jerome R. Hellerstein and Walter Hellerstein, State and Local Taxation: Cases and Materials 385 (7th ed. 2001).

Ohio's taxing authority is circumscribed by the same Public Law 86-272 limitations as any other state. In order for Ohio to tax these receipts, it must demonstrate that taxpayer's activities within the state exceed the solicitation of sales, that these activities are not simply ancillary to the sales solicitations, and that the activities go beyond the de minimis standard. There is little indication that taxpayer's Ohio activity exceeds these standards. Again, it is noteworthy that Ohio's taxing authority would seem to agree because there is no evidence that Ohio has deemed these receipts subject to Ohio's net income tax. There seems little likelihood that Ohio would have the authority to subject taxpayer to Ohio's income tax; taxpayer's Ohio sales receipts were correctly "thrown-back" to Indiana pursuant to IC 6-3-2-2.

B. Michigan Sales Income.

Taxpayer argues that its Michigan sales income should not have been thrown back to Indiana because it was subject to Michigan's Single Business Tax (MSBT). Accordingly, taxpayer argues that it "has independent and additional support for nexus with the State of Michigan."

The Department must disagree with taxpayer's conclusion that imposition – or the likelihood of imposition – of the MSBT precludes Indiana from throwing back its Michigan sourced sales receipts. IC 6-3-2-2(n) precludes the state from throwing back sales receipts in those states in which "taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege for doing business, or a corporate stock tax." As the Indiana Tax Court has stated, "The MSBT is a type of value added tax VAT." First Chicago NBD Corp. v. Dept. of State Revenue, 708 N.E.2d 631, 632 (Ind. Tax Ct. 1999). "Although taxable income is one portion of the tax base formula, *the MSBT is not measured by or based on income*." Id. at 634 (*Emphasis added*). "The law [Public Law 86-272] applies only to net income taxes . . . and does not apply to the general business of taxes of states that do not employ a net income measure, such as Michigan's Single Business Tax, which is a form of value-added tax." Hellerstein & Hellerstein at 389.

The Michigan activities of taxpayer's independent representatives may subject taxpayer to the MSBT, but that fact is irrelevant in determining whether Indiana may throw-back taxpayer's Michigan sourced sales receipts. The Michigan sales were correctly "thrown-back" to Indiana pursuant to IC 6-3-2-2.

C. Foreign Sales Income.

Taxpayer maintains that its sales receipts from Puerto Rico, Ecuador, and Mexico should not be thrown back to Indiana because, "P.L. 86-272 does not protect these sales from taxation in those countries."

For the purposes of determining whether a taxpayer is subject to the taxing jurisdiction of another state pursuant to 45 IAC 3.1-1-64, "[t]he term 'state' means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof." IC 6-3-1-25. Accordingly, the jurisdictions to which taxpayer here refers – Puerto Rico, Ecuador, and Mexico – fall within the definition of "state," and the receipts obtained from those three jurisdictions are properly considered as potentially subject to the throw-back rule.

Taxpayer may be correct in its assertion that Public Law 86-275 does not prevent a foreign jurisdiction from levying an income tax on the receipts taxpayer obtained from customers within those foreign jurisdictions. However, taxpayer has done nothing to demonstrate that it is subject to a net income tax in Puerto Rico, Ecuador, or Mexico. Accordingly, under IC 6-3-2-2, the receipts taxpayer obtained from its customers in Puerto Rico, Ecuador, and Mexico were properly thrown-back to Indiana.

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of the Ten-Percent Negligence Penalty.

According to taxpayer, it "had a position of substantial authority for not reflecting sales as 100 [percent] Indiana when the original returns were filed." As a result of the Department's own "incorrect application of the throw back rule, penalties should not be assessed."

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

The Department respectfully disagrees with taxpayer's argument that it was entirely justified in not reporting *any* of its out-of-state income and that its decision to do so was based upon "ordinary business care." The Department must decline the opportunity to abate the consequent penalty.

FINDING

Taxpayer's protest is respectfully denied.

DK/JM/MR – 042602